

Message Text

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ACTION EA-09

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INFO USLO PEKING

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SUBJECT: PROSPECTS FOR JAPAN-CHINA OIL TRADE

REF: (A) 75 TOKYO 18173, (B) TOKYO 2659

SUMMARY. DESPITE PERSISTENT AND COMPLICATED OBSTACLES, PROSPECTS REMAIN FAVORABLE THAT SINO-JAPANESE OIL TRADE WILL EXPAND MODERATELY BUT STEADILY INTO THE 1980'S REACHING PERHAPS 20-30 MILLION TONS. AS GOJ PLANNERS SEE IT, THERE IS A BASIC COMPLEMENTARY OF INTERESTS THAT WILL LEAD BOTH SIDES TO OVERCOME PROBLEMS OF QUANTITY, QUALITY AND PRICE. ASSUMING THE CURRENT POLITICAL STRUGGLES IN CHINA DO NOT LEAD TO A MAJOR REVERSAL OF ECONOMIC POLICY, CHINA'S EXPORTS OF OIL WILL CONTINUE TO BE A MAJOR SOURCE OF FOREIGN EXCHANGE TO BUT NEEDED PLANT AND EQUIPMENT TO MEET ECONOMIC DEVELOPMENT GOALS. JAPAN OFFERS THE MOST SIGNIFICANT MARKET FOR CHINESE CRUDE. CONVERSELY, CHINA PRESENTS THE BEST OF CRUDE SUPPLY AWAY FROM VOLATILE MIDDLE EAST. GOJ PLANNERS ARE WELL AWARE THAT THE GROWING IMPORTANCE OF CHINESE OIL WILL HAVE POLITICAL RAMIFICATIONS, ESPECIALLY IF JAPANESE DEMAND DOES NOT KEEP PACE WITH CHINESE PRODUCTION, BUT IN GENERAL THEY BELIEVE THE BENEFITS OUTWEIGH THE RISKS. FROM A U.S. INTERESTS POINT OF VIEW, WE AGREE. END SUMMARY.

1. WIDESPREAD AGREEMENT EXISTS WITHIN THE GOJ THAT IMPORTING MORE OIL FROM CHINA IS IN JAPAN'S NATIONAL INTEREST. JAPAN DEPENDS ON THE MIDDLE EAST FOR 78 PERCENT OF ITS CRUDE OIL, AND FEW OPPORTUNITIES EXIST TO DILUTE THAT DEPENDENCE. HOPES FOR PARTICIPATING IN RAPID DEVELOPMENT OF SIBERIAN ENERGY RESOURCES HAVE FOUNDERED ON COST, RUSSIAN DEMANDS TO HELP BUILD THE BA-AM RAILROAD NEAR THE CHINESE BORDER, AND RELUCTANCE TO PROCEED WITHOUT U.S. INVOLVEMENT. OFFSHORE VIETNAM OFFERS TANTALIZING POSSIBILITIES, BUT AS YET LITTLE MORE. CONCERNED THAT A CHRONIC IMBALANCE IN THE BILATERAL BALANCE OF TRADE (JAPAN IS CHINA'S LARGEST TRADING PARTNER) MAY HARM OVERALL RELATIONS, THE JAPANESE ALSO SEE CHINESE OIL AS THE ONE COMMODITY THEY ARE INTERESTED IN IMPORTING IN QUANTITY.

2. THE JAPANESE PETROLEUM INDUSTRY HAS IN PRINCIPLE
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ACKNOWLEDGED THE IMPORTANCE OF CHINA OIL TRADE, BUT HAS THUS FAR SUCCESSFULLY RESISTED OFFICIAL CAJOLING TO BEAR THE FINANCIAL BURDEN. IN FACT THE INDUSTRY HAS ANNOUNCED THAT IT WANTS TO CUT CHINESE CRUDE IMPORTS 25 PERCENT TO 6 MILLION TONS (100,000 B/D) IN 1976. THE LINGERING ECONOMIC RECESSION LARGELY ACCOUNTS FOR THE PETROLEUM INDUSTRY'S OBSTINANCY. TOTAL CRUDE OIL IMPORTS FELL 6 PERCENT LAST YEAR (THE SECOND STRAIGHT

YEAR OF DECLINE) AND REFINERY UTILIZATION LEVELS DROPPED TO 71 PERCENT OF CAPACITY. JAPAN'S REFINERS HAVE SIMPLY NOT BEEN IN THE MARKET FOR ANY ADDITIONAL CRUDE, ESPECIALLY AT CHINA'S PRICES. ADDITIONALLY, UNDER MITI'S STRONG ADMINISTRATIVE GUIDANCE CONCERNING ENVIRONMENTAL PROTECTION STANDARDS, JAPANESE REFINERS HAVE HAD TO INSTALL EXPENSIVE DESULFURIZATION FACILITIES TO HANDLE MIDDLE EAST CRUDE. WITH MIDDLE EAST CRUDE IMPORTS DOWN 5 PERCENT IN 1975, THESE FACILITIES HAVE BEEN GREATLY UNDERUTILIZED.

3. THE QUALITY OF CHINESE CRUDE OIL ALSO POSES SERIOUS PROBLEMS FOR JAPANESE REFINERS. CHINESE CRUDE IS LOW IN SULFUR, WHICH MAKES IT PARTICULARLY SUITABLE FOR BURNING BY THE ELECTRIC POWER INDUSTRY. ON THE OTHER HAND, IT HAS HIGH PARAFIN CONTENT. TO YIELD THE MORE PROFITABLE LIGHTER OILS NOW BEING REFINED FROM LOW-PARAFFIN MIDDLE EAST CRUDES, JAPANESE REFINERS WOULD HAVE TO INSTALL EXPENSIVE NEW CRACKING FACILITIES. ESTIMATES OF THE COST OF 100,000 B/D PLANT RANGE FROM A LOW OF \$140 MILLION TO A HIGH OF MORE THAN \$300 MILLION. THREE REFINERS--IDEMITSU, THE LARGEST OF THE "NATIONAL CAPITAL" REFINERS, AND TWO SMALLER REFINERS ASSOCIATED WITH KYODO OIL--ARE PRESENTLY STUDYING THE POSSIBILITY OF CONSTRUCTING CRACKING FACILITIES TO HANDLE CHINESE CRUDE, BUT IT IS DOUBTFUL THEY WOULD DO SO WITHOUT MASSIVE GOJ AID--OR WITHOUT A BIG BREAK IN THE PRICE OF CHINESE CRUDE. FOR THE MOMENT, BASED ON PRICE DIFFERENCES, EVEN THE ELECTRIC POWER INDUSTRY PREFERS TO BURN DESULFURIZED MIDDLE EASTERN CRUDE. CALCULATIONS DIFFER, BUT GENERALLY IT IS ASSERTED THAT IF CHINA DROPS ITS PRICE FROM THE PRESENT \$12.30 TO AROUND THE \$11.50 OF BENCHMARK ARABIAN LIGHT THE COST OF NEW CRACKING FACILITIES COULD

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BE RECOVERED--PROVIDED JAPAN IS WELL INTO AN ECONOMIC UPTURN.

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INFO USLO PEKING

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4. INSTITUTIONAL PROBLEMS HAVE ALSO PLAYED A PART. AS
A PRACTICAL MATTER THE MINISTRY OF INTERNATIONAL TRADE
AND INDUSTRY (MITI) HAS DIRECT INFLUENCE OVER ONLY
A SMALL NUMBER OF REFINERS. ABOUT FIFTY PERCENT OF
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JAPAN'S REFINING CAPACITY IS OWNED BY REFINERS AFFILIATED
AS JOINT VENTURES WITH MAJOR INTERNATIONAL OIL COMPANIES.
AND THE LARGEST NON-AFFILIATED REFINERS HAVE LONG-STANDING
RELATIONSHIPS WITH THE MAJORS THAT PROTECT THEM FROM
MITI'S PRESSURE. ONLY ABOUT 20 PERCENT OF REFINING
CAPACITY IS THUS AVAILABLE TO ABSORB CHINESE CRUDE UNDER
MITI'S GUIDANCE.

5. GOJ PLANNERS ARE EVERTHELESS CONFIDENT THAT BEGINNING IN LATE 1976 JAPAN-CHINA OIL TRADE WILL BE PLACED ON A STABLE LONG-TERM GROWTH PATH. BASICALLY THEY ASSUME THAT UNLESS POLITICAL TURMOIL, OR A POLICY REVERSAL, COMPLETELY DISRUPTS CHINA'S ECONOMIC DEVELOPMENT PLANS, CHINA WILL CONTINUE TO EXPORT OIL TO PAY FOR NEEDED IMPORTS OF PLANT AND MACHINERY. JAPANESE ESTIMATES PLACE CHINA'S EXPORTABLE SURPLUS OF CRUDE AT 120 MILLION TONS IN 1985. WHETHER OR NOT THIS ESTIMATE IS ACCURATE, THE CHINESE HAVE TOLD THE JAPANESE THEY WANT TO SELL LOTS MORE OIL. EVEN IF WORLD PETROLEUM PRICES REMAIN HIGH-- AND GOJ PLANNERS ASSUME THEY WILL--THE JAPANESE ANTICIPATE THAT CHINA WILL HAVE TO DROP ITS PRICE TO STAY COMPETITIVE, OR CURTAIL ECONOMIC DEVELOPMENT. THE CHINESE HAVE ALREADY ENGAGED IN LIMITED PRICE COMPETITION AGAINST INDONESIA: IT CAN BE ARGUED THAT THE 50 CENT PRICE DIFFERENCE LED TO THE 3 PERCENT DECLINE IN INDONESIA'S SHARE OF THE JAPANESE MARKET LAST YEAR. BUT EVEN SHOULD CHINA OPT FOR SLOWER GROWTH, JAPAN SHOULD REMAIN THE PRIMARY MARKET FOR CHINESE OIL.

6. TO PROVIDE AN ANCHOR FOR STABLE LONG TERM OIL TRADE, BOTH THE GOJ (ESPECIALLY MITI) AND CHINA WOULD LIKE TO CONCLUDE A FORMAL LONG TERM AGREEMENT, THERE HAS BEEN LITTLE AGREEMENT, HOWEVER, AS TO WHAT FORM THE COMMITMENT SHOULD TAKE OR AS TO HOW MUCH OIL JAPAN SHOULD PROMISE TO ACCEPT. THE FOREIGN OFFICE ARGUES--SO FAR SUCCESSFULLY-- FOR A VERY LOOSE AGREEMENT SINCE THE GOJ CANNOT GUARANTEE THAT JAPANESE REFINERS WILL ALWAYS ACCEPT THE AMOUNTS STIPULATED. THIS MAY WELL, THEY FEAR, GENERATE NEEDLESS FRICTIONS. CONSEQUENTLY, THE AMOUNTS DISCUSSED HAVE DECLINED SHARPLY. FROM AN EARLIER GOAL OF EVENTUALLY REACHING 100 MILLION TONS, THE JAPANESE OFFERED IN JANUARY TO TAKE 10

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MILLION TONS IN 1977, RISING TO 15 MILLION "PLUS ALPHA" IN 1982. ACCORDING TO MITI DIRECTOR FOR PETROLEUM PLANNING OZU, THE JAPANESE TENTATIVELY OFFERED TO TAKE ANOTHER 15 MILLION TONS AS THE "PLUS ALPHA." MITI CALCULATED THIS PORTION, HE SAID, BY ASSUMING ONE 100,000 B/D CRACKING FACILITY WILL TRANSLATE INTO AN ADDITIONAL 5 MILLION TONS PER YEAR OF IMPORTED CHINESE CRUDE. DESPITE ACTIVE MITI PROMOTION, OBTAINING FINANCING FOR THE CRACKING FACILITIES HAS BEEN SEVERELY HAMPERED BY THE RECESSION, BUT AS THE ECONOMY TURNS SOLIDLY UPWARD, OZU IS CONFIDENT THE JAPAN INDUSTRIAL DEVELOPMENT BANK WILL EXTEND OFFICIAL CREDITS TO AT LEAST TWO OR THREE REFINERS. IF THE CHINESE WOULD THEN BEAR PART OF THE BURDEN BY LOWERING THE PRICE SOMEWHAT, THE WAY WILL BE

OPENED TO STEADY GROWTH. THE KEY, OZU SAID, LIES IN PROVIDING AN ELEMENT OF STABILITY TO EVEN OUT MARKET FLUCTUATIONS. THEN CHINESE ECONOMIC PLANNERS CAN CONFIDENTLY DETERMINE PRODUCTION SCHEDULES AND (JAPANESE) CAPITAL GOODS PURCHASES. OZU ADDED THAT THERE WOULD BE NO DIRECT LINK BETWEEN SPECIFIC JAPANESE EXPORT ITEMS (E.G., STEEL OR PLANTS) AND CHINESE OIL EXPORTS. (THERE IS OF COURSE AN IMPLICIT TRADE-OFF.)

7. GOJ PLANNERS ARE HARDLY IGNORING THE POLITICAL IMPLICATIONS OF EXPANDING CHINA OIL TRADE. BUT THEY SEE ANY ATTEMPT BY CHINA TO USE OIL AS A MEANS TO ATTAIN POLITICAL ENDS AS A TWO-EDGED SWORD AND ARE CONFIDENT THEY CAN MANAGE THEIR OVER-ALL RELATIONS IN SUCH A WAY AS TO AVOID A SERIOUS CONFRONTATION OVER OIL. TO THAT END MITI AND THE FOREIGN MINISTRY AGREE THAT IT WOULD BE UNWISE TO DEPEND ON CHINA FOR MORE THAN 15 PERCENT OF OIL REQUIREMENTS. AFTER ALL, IT IS PRECISELY BECAUSE OF JAPAN'S OVERWHELMING DEPENDENCE ON THE MIDDLE EAST FOR OIL THAT DIVERSIFICATION IS SO IMPORTANT. (AT PRESENT SAUDI ARABIA AND IRAN EACH SUPPLY MORE THAN 20 PERCENT.)

8. COMMENT. IT SEEMS TO US THAT AN ORDERLY EXPANSION OF SINO-JAPANESE OIL TRADE IS IN THE U.S. INTEREST. A DIMINUTION OF JAPANESE DEPENDENCE ON THE MIDDLE EAST FOR OIL SHOULD ENHANCE JAPAN'S INDEPENDENCE AND

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ABILITY TO COOPERATE WITH THE U.S. AND OTHER INDUSTRIAL CONSUMERS. ADDITIONALLY, A HEALTHY AND BALANCED SINO-JAPANESE ECONOMIC RELATIONSHIP WOULD CONTRIBUTE TO STABILITY IN EAST ASIA.

ON THE OTHER HAND, THE JAPANESE, ESPECIALLY MITI, MAY BE UNDERESTIMATING POTENTIAL DIFFICULTIES. REGARDLESS OF WHETHER OR NOT THE CHINESE DECIDE TO RELY HEAVILY ON IMPORTS OF CAPITAL GOODS AND TECHNOLOGY AS AN ENGINE FOR ECONOMIC DEVELOPMENT, EVEN MODERATE INCREASES IN OIL EXPORTS REQUIRE SUBSTANTIAL INVESTMENT IN PRODUCTION, TRANSPORTATION AND HARBOR FACILITIES. THE CHINESE HAVE ALREADY EXPRESSED STRONG DISSATISFACTION WITH THE LOW LEVEL OF LIFTINGS IN 1975 AND PROJECTED LIFTINGS IN 1966. CUTTING RECENT DELIVERIES TO SHOW HOW THEY FEEL. ALTHOUGH THE PROBLEM HASNOT AFFECTED POLITICAL RELATIONS DIRECTLY, IT COULD DO SO, ESPECIALLY AT HIGHER LEVELS OF OIL TRADE.

BARRING UNFORESEEN POLITICAL PRESSURES FROM THE CHINESE, THE ACTUAL PACE OF GROWTH IN JAPAN-CHINA OIL TRADE WILL ULTIMATELY DEPEND ON THE PACE OF ECONOMIC GROWTH IN JAPAN. GEARED TO HANDLE MIDDLE EAST TYPE

CRUDES, JAPANESE REFINERIES ARE NOW OPERATING WELL
BELOW CAPACITY. THE REFINERS AND INDUSTRY ARE NOT BEING
ASKED TO SUBSTITUTE CHINESE OIL FOR MIDDLE EAST CRUDES:
RATHER CHINA'S GREATER SHARE WILL COME OUT OF THE EVENTUAL
GROWTH IN OVERALL DEMAND FOR OIL. FORECASTS DEVELOPED
LAST AUTUMN PLACED JAPANESE PETROLEUM DEMAND AT 780
MILLION TONS IN 1985: IF IMPORTS FROM CHINA AMOUNTED
TO 15 PERCENT, ITS SHARE WOULD BE 72 MILLION TONS.
GIVEN THE PREVAILING CONSENSUS, WHICH WE SHARE, THAT
JAPAN FACES AN ERA OF MODERATE ECONOMIC GROWTH,
THESE FIGURES, WHICH ARE NOW UNDER REVIEW, ARE LIKELY
TO BE REVISED DOWNWARD. BUT EVEN A 10 PERCENT PER
YEAR COMPOUNDED GROWTH RATE IN CHINA OIL TRADE,
STARTING WITH SAY 10 MILLION TONS IN 1977, WOULD RESULT
IN CHINESE CRUDE IMPORTS OF A LITTLE MORE THAN 20
MILLION TONS IN 1985. GIVEN THE LEAD TIMES REQUIRED
AND EXPENSE OF NEW CRACKING FACILITIES, THIS LOWER
FIGURE IS PROBABLY CLOSER TO THE MARK THAN THE EARLIER
JAPANESE ESTIMATE ABOVE.

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